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THE 1978 NAVY SHIPBUILDING CLAIMS SETTLEMENT AT  
LITTON/INGALLSSSHIPBUILDING--A FINAL REPORT(U) GENERAL  
ACCOUNTING OFFICE WASHINGTON DC NATIONAL SECURITY AND  
04 APR 84 GAO/NSIAD-84-53

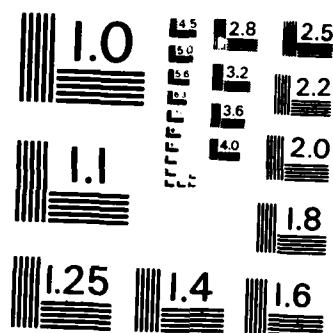
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BY THE COMPTROLLER GENERAL

# Report To The Congress

OF THE UNITED STATES

## The 1978 Navy Shipbuilding Claims Settlement At Litton/Ingalls Shipbuilding--A Final Report

The 1979 Defense Appropriation Authorization Act authorizes the Comptroller General to review two contracts with Litton Systems, Inc., Ingalls Shipbuilding Division, for building Navy landing helicopter assault and DD-963 destroyer ships. These contracts were involved in a 1978 shipbuilding claims settlement.

This review is to insure that funds authorized to pay for contract modifications made in the interest of national defense are used only on the two contracts and that the contractor does not use such funds to realize any total combined profit on these contracts.

GAO found that the authorized funds were used only on the specified contracts and that the contractor did not realize any total combined profit on the contracts.

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON D.C. 20548

B-197665

To the President of the Senate and the  
Speaker of the House of Representatives

This is our fourth report on the status of two contracts (N00024-69-C-0283 and N00024-70-C-0275) the Navy awarded to Litton Systems, Inc., Ingalls Shipbuilding Division, Pascagoula, Mississippi, for 5 landing helicopter assault (LHA) and 30 Spruance class destroyer (DD-963) ships. This report covers the period from August 1, 1982, through the contract closeout agreement executed in November 1983. Our first three reports (PSAD-80-39, Apr. 22, 1980; PLRD-82-8, Oct. 6, 1981; and GAO/PLRD-83-26, Mar. 3, 1983) covered the period from June 20, 1978 (date of settlement) to August 1, 1982.

The LHA and DD-963 contracts were awarded in 1969 and 1970, respectively. Design and construction problems emerged early in the LHA program and, as a result, schedules slipped and costs escalated. Such problems also affected the DD-963 program. Both contracts subsequently became the subject of several years of administrative and legal proceedings between the Navy and the contractor resulting from numerous claims and counterclaims. In 1978 the total amount claimed by Litton was \$1,088 million.

As of June 1978, Litton's estimated cost at completion of the two contracts was \$4,726 million which would result in a loss of \$647 million if nothing was received from present or future claims against the Navy. On June 20, 1978, Litton and the Navy agreed to a claim settlement that was based on the above estimate. The contracts were modified, accordingly, under authority of Public Law 85-804, which allows the President to modify contracts without regard to certain other laws in the interest of national defense.

The settlement provided for a \$265 million contract price increase to cover existing company claims against the Navy. It also provided for (1) the contractor to absorb a \$200 million loss through adjusting the LHA contract billing base, (2) the Navy to absorb a \$182 million loss through increasing the contract price under the authority of Public Law 85-804, (3) the Navy and the contractor to share 20 and 80 percent of future cost underruns, respectively, and (4) the Navy and the contractor to share future cost overruns equally up to \$100 million and the contractor to be solely responsible for costs above that amount. In addition, the Navy would not assume any responsibility for escalation (economic price adjustments) during the remaining terms of the contracts.

Our review was performed pursuant to section 821 of Public Law 95-485 (1979 Department of Defense Appropriation Authorization Act). Section 821 authorizes the Comptroller General to perform reviews of these contracts as he determines necessary to insure that funds authorized to provide relief under Public Law 85-804 are used only in connection with the contracts and that the prime contractor does not realize any total combined profit on the contracts.

During our review, we (1) updated our prior review of procedures and controls and made a limited test of charges to determine if costs were charged properly to the individual contracts and (2) examined contract records and held discussions with contractor and Navy officials to determine the combined profit/loss status of the contracts. We also examined contract payments and related costs to determine if Public Law 85-804 funds were used only on the two contracts.

We directed our review primarily to the two principal objectives set forth in section 821 and to the related contract closeout activities. We did not make a detailed analysis of the contractor's estimated and actual costs to identify specific areas and reasons for any combined overrun or underrun of estimated costs on these two contracts. Our review was made in accordance with generally accepted government auditing standards.

Contract closeout negotiations between Litton/Ingalls and the Navy have been concluded. The parties established a tentative combined total final price for the two contracts and a final price for the LHA contract. These prices were reflected in a contract closeout modification to the LHA contract that was executed in November 1983.

With respect to our determinations under section 821, we found no evidence to indicate that Public Law 85-804 funds authorized for the 1978 claims settlement were not used on the specified contracts.

In addition, we calculated a final combined profit/loss on the contracts. Our calculation showed a profit of \$13 million. (See table 2.) Both parties agreed in the negotiated closeout that all payments under the contracts shall be in accordance with restrictions in section 821, as interpreted by us.<sup>1</sup>

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<sup>1</sup>See GAO/PLRD-83-26, March 3, 1983, pp. 52-54.

Accordingly, the combined profit was not paid to the contractor and the negotiated price reflected a break-even position. Therefore, the negotiated closeout agreement complies with the congressional prohibition against the realization of a combined profit on these contracts.

In its comments on this report (see app. I), Litton/Ingalls continues to hold the opinion (expressed in our prior reports) that calculations under section 821 of Public Law 95-485 apply only to the LHA and DD-963 contracts as of the date of settlement (1978) and result in a total combined loss of \$19 million on the contracts. (See table 2.) Litton/Ingalls states that the contract closeout settlement agreement was reached in the spirit of compromise. On the other hand, the Department of Defense agrees with our facts and conclusions.

The following sections discuss the use of authorized funds, the combined profit/loss calculation, and the closeout agreement in more detail.

#### USE OF AUTHORIZED FUNDS

We are required to insure that funds authorized under Public Law 85-804 are used only in connection with the specified contracts. We found no evidence to indicate that Public Law 85-804 funds were used on other than the LHA and DD-963 contracts.

On the basis of the contract price established during closeout negotiations, we determined that cash payments made to the contractor, in accordance with the terms of the contracts, exceeded allowable costs by more than \$4 million. When agreement on contract price was reached during closeout negotiations, in July 1983, the contractor reimbursed the Navy for this amount. Until the agreement was reached, the \$4 million was available for other corporate uses. However, we found no evidence to indicate that these funds were used on projects other than the LHA and DD-963 contracts.

Details relating to the overpayment are shown in table 1.



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Table 1

	Contract <sup>a</sup>		
	<u>LHA</u>	<u>DD-963</u>	<u>Total</u>
	----- (millions) -----		
Cumulative allowable costs:			
Booked costs <sup>b</sup>	\$1,451	\$3,215	\$4,666
Manufacturing process development <sup>c</sup>	-21	-41	-62
Legal fees	- 2		- 2
Cost Accounting Standard 414 <sup>d</sup>	4	11	15
Total	<u>\$1,432</u>	<u>\$3,185</u>	<u>\$4,617</u>
Cumulative cash receipts:			
Progress billings	1,134	2,514	3,648
Escalation <sup>e</sup>	162	792	954
Ship-silencing incentive fee <sup>f</sup>	-	18	18
Total	<u>\$1,296</u>	<u>\$3,325</u>	<u>\$4,621</u>
Cash receipts exceeding reimbursable costs	<u>\$ -136</u>	<u>\$ 140</u>	<u>\$ 4</u>

<sup>a</sup>Figures may not total due to rounding.

<sup>b</sup>Costs incurred and recorded in contractor's books of account.

<sup>c</sup>Generally defined by Litton/Ingalls as effort expended to develop and refine the manufacturing process and procedures in the early and subsequent use of the shipyard facility.

<sup>d</sup>Imputed interest costs.

<sup>e</sup>Payments to cover inflationary price increases.

<sup>f</sup>Payments for reductions in ship operating noise.

#### COMBINED PROFIT/LOSS POSITION

We are also required to insure that the contractor does not realize any total combined profit on the LHA and DD-963 contracts. Our calculation of the profit or loss position on these contracts shows an estimated profit of \$13 million at contract closeout. The basis for the calculation is discussed below and illustrated in table 2.

Table 2

	Contract <sup>a</sup>		
	<u>LHA</u>	<u>DD-963</u>	<u>Total</u>
	----- (millions) -----		
Estimated cost at completion as of August 1, 1983	\$1,432	\$3,191	\$4,623
Less: Post-settlement contract modifications <sup>b</sup>	<u>-13</u>	<u>-111</u>	<u>-124</u>
Estimated cost for sharing purposes	1,419	3,080	4,499
Estimated cost at completion as of 1978 settlement date	<u>1,500</u>	<u>3,226</u>	<u>4,726</u>
Cost underrun	<u>81</u>	<u>146</u>	<u>227</u>
Contractor's share of underrun	65	117	181
Share of estimated loss to be absorbed by contractor <sup>c</sup>	<u>-200</u>	<u>-</u>	<u>-200</u>
Estimated loss at completion as of August 1, 1983 - unadjusted	-135	117	- 19
Add: Profit on post-settlement change orders <sup>d</sup>	2	12	14
Ship-silencing incentive feed <sup>e</sup>	<u>-</u>	<u>18</u>	<u>18</u>
Estimated net profit or loss (-) at completion as of August 1, 1983 <sup>e</sup>	<u>\$ -134</u>	<u>\$ 147<sup>f</sup></u>	<u>\$ 13</u>

<sup>a</sup>Figures may not total due to rounding.

<sup>b</sup>The August 1, 1983, estimated cost at completion, which is the negotiated closeout contract price plus estimated costs to complete, has been reduced by \$124 million in contract modifications. This reduction is to convert to a basis consistent with the estimate at the time of the claims settlement so that an estimated cost for sharing purposes can be determined.

<sup>c</sup>Settlement provides that estimated loss be absorbed entirely on LHA contract.

<sup>d</sup>See GAO/PLRD-83-26, March 3, 1983, pp. 40-52 and p. 54.

<sup>e</sup>Net profit is total receipts under the contracts minus costs allowable under the Defense Acquisition Regulation.

<sup>f</sup>The final estimated total combined profit will be affected by any costs that Litton/Ingalls incurs due to pending litigation with subcontractors. Outstanding subcontract claims against Litton/Ingalls total about \$30 million.



The 1978 claims settlement provides that the Navy and the contractor share 20 and 80 percent of the cost underrun, respectively. The \$200 million estimated loss that Litton/Ingalls agreed to absorb as part of the claims settlement has been reduced, due to cost underruns, to \$19 million. This reduction is based on contract prices established during contract closeout negotiations and on costs incurred through July 31, 1982.

Various fees paid to the contractor are included in the profit/loss determination. One such fee is profit on change orders. The contractor is allowed to earn a profit on individual change orders made after April 30, 1978, subject to the limitations of the 1979 Department of Defense Appropriation Authorization Act on the use of Public Law 85-804 funds for payment of any total combined profit on the two contracts. Another fee is the ship-silencing incentive fee that is part of the total contract compensation.

Litton/Ingalls considers that contract changes made after the claims settlement earned a profit of about \$14 million. The total ship-silencing incentive fee is about \$18 million. As shown in table 2, when these fees are included in the calculation, the \$19 million loss becomes a combined estimated profit of about \$13 million at completion of the contracts.

#### CONTRACT CLOSEOUT ACTIONS

After conducting contract settlement and closeout negotiations over an extended period, the Navy and the contractor agreed to individual contract prices and a combined price for the two contracts based on allowable costs incurred through July 31, 1982. The combined price established reflects a break-even profit/loss position. No combined profit will be realized by the contractor. Therefore, the negotiated agreement complies with the congressional prohibition against the realization of a combined profit on the contracts. The agreement was reflected in a contract closeout modification to the LHA contract that was executed in November 1983.

Several items remain open and were not included in the negotiated closeout agreement. The LHA contract has been closed out, but the DD-963 contract will remain open to account for any costs incurred on the open items after July 31, 1982. The Navy will reimburse the contractor for all allowable costs subsequently incurred without any provision for profit. These costs and the negotiated contract price will become the basis for a combined final price and a closeout modification on the DD-963 contract after all outstanding items have been completed.

The principal items remaining open are (1) pending claims and counterclaims between Litton/Ingalls and three subcontractors with an estimated cost to the government of up to \$30 million, (2) an insurance claim for about \$1.4 million relating to the LHA-4 starboard propulsion system, (3) warranty/guaranty work at an estimated cost of \$0.9 million, and (4) packing, handling, and crating residual material at an estimated cost of \$0.4 million. We will monitor the disposition of all open items.

The principal agreements, in addition to contract prices, reached during the closeout negotiations were as follows:

- The contractor agreed to withdraw with prejudice all claims relating to manufacturing process development costs.
- All payments under the contracts shall be in accordance with restrictions set forth in section 821 of the 1979 Department of Defense Appropriations Authorization Act as interpreted by us.
- Any Government Armed Services Board of Contract Appeals counterclaims as they apply to the contracts will be withdrawn.
- The contractor relinquished ownership in residual material on the two contracts for a total of \$0.7 million, which was charged to the contracts.

#### CONCLUSIONS

Our review of the 1978 Navy shipbuilding claims settlement at Ingalls Shipbuilding Division of Litton Systems, Inc., disclosed that (1) Public Law 95-804 funds were used only on the specified contracts and (2) the contractor did not realize any total combined profit on such contracts as stipulated in section 821 of Public Law 95-485.

#### LITTON/INGALLS AND DEPARTMENT OF DEFENSE COMMENTS

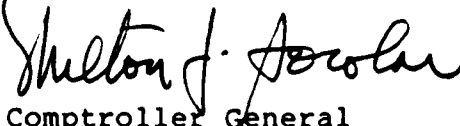
As it did in previous reports, Litton/Ingalls continues to hold the opinion that calculations under section 821 of Public Law 95-485 apply only to the LHA and DD-963 contracts as of the date of settlement (1978) and result in a total combined loss of \$19 million on the contracts. It stated that the contract closeout settlement agreement with the Navy was reached in the spirit of compromise. (See app. I.)

The Department of Defense agreed with the facts and conclusions presented in this report. (See app. II.)

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We do not contemplate any further reports on these two contracts. Results of final action on the outstanding items and the related impact, if any, on the final closeout of the DD-963 contract will be provided, periodically, in letters to the Chairmen, Senate and House Committees on Armed Services.

We are sending copies of this report to the Chairmen, Senate and House Committees on Armed Services; Senator William Proxmire; and the President, Ingalls Shipbuilding Division of Litton Systems, Inc.

*for*   
Comptroller General  
of the United States



**INGALLS**  
Shipbuilding

100-1001-235-1111

December 13, 1983

Leonard Erb, President

83-35-EBR/207

Mr. Frank C. Conahan  
Director  
United States General Accounting Office  
Washington, D. C. 20548

Dear Mr. Conahan:

Ingalls has reviewed your draft report on the 1978 Navy Shipbuilding Claims Settlement forwarded by your letter of November 18, 1983.

Although we continue to hold the opinion that calculations under section 821 of Public Law 95-485 apply only to the LHA and DD963 Contracts as of the date of settlement and result in a total combined loss of \$19 million, in the spirit of compromise we have reached a settlement agreement with the U.S. Navy as discussed in your draft report. We request that your report reflect this unchanged Ingalls opinion.

We have no further comments to your report.

Sincerely,

  
Leonard Erb

LE/gcm



## OFFICE OF THE UNDER SECRETARY OF DEFENSE

WASHINGTON D C 20301

RESEARCH AND  
ENGINEERING

19 DEC 1983

Frank C. Conahan, Director  
National Security and  
International Affairs Division  
U. S. General Accounting Office  
441 G. St. N.W.  
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "The 1978 Navy Shipbuilding Claims Settlement at Litton/Ingalls Shipbuilding--A Final Report," dated November 21, 1983 (GAO Code No. 942259; OSD Case No. 6403). In essence, GAO concludes that its review of the shipbuilding claims settlement disclosed (1) that the authorized funds were used only in the specified contracts and (2) that the contractor did not realize any total combined profit on the contracts (as stipulated in Section 821 of Public Law 95-485).

The DoD has reviewed the report and agrees with the facts and conclusions. Further comment, therefore, is unnecessary.

The DoD appreciates the professional manner in which the GAO has conducted the annual reviews of the Litton/Ingalls Shipbuilding claims settlement.

Sincerely,

MARY ANN GILLEECE  
DEPUTY UNDER SECRETARY  
(ACQUISITION MANAGEMENT)

(942259)

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